WILSHIRE CONSULTING

Attachment 3

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January 30, 2011

Dr. George Diehr
Chair of the Investment Committee
California Public Employees' Retirement System
400 Q Street
Sacramento, CA 95814

Re: 2011 Real Estate Strategic Plan

Dear Dr. Diehr:

You requested Wilshire's opinion with respect to the Strategic Plan proposed by the Real Estate Unit. This plan is designed to provide long term guidance for the management of the asset class.

Overview and Recommendation

Wilshire recommends that the Investment Committee approve the Strategic Plan. We have discussed the Plan with the Real Estate Unit and PCA and believe that the Plan reflects the Investment Committee's wishes that Real Estate provide stable cash flow and diversification for the total fund.

We note below three issues of which the Investment Committee should be aware and provide input, as appropriate.

Background

The proposed Strategic Plan would cause a significant realignment of the real estate portfolio over a long period of time. As the vast majority of the real estate portfolio is illiquid, rapid turnover in the portfolio would be extraordinarily expensive. Therefore, the evolutionary shift as proposed in the Plan is prudent.

Over the life of this Strategic Plan, the real estate portfolio would place greater emphasis on core real estate, with less use of value added and opportunistic strategies. This will reposition the portfolio to exhibit more stable, income producing characteristics and will reduce the portfolio's historical reliance on leverage to drive returns. The portfolio may still invest in value-added and opportunistic projects, but those investments will be made opportunistically, rather than in an ongoing pursuit of return maximization. Wilshire, PCA, and Staff believe that this is in accordance with the Investment Committee's desires and the strategic role for the real estate portfolio as expressed during the asset allocation process.

Wilshire wishes to raise three issues for the Investment Committee's consideration. First, while the Strategic Plan provides great detail on how the "new" portfolio will be managed, it is critical to the success of the overall real estate portfolio that the "legacy" portfolio be well managed on an ongoing basis. The proposed legacy portfolio represents 53% of the current real estate portfolio. These investments should be managed to transition from the legacy portfolio to the new portfolio (in cases where that is appropriate) as buying core assets in the current real estate environment may be significantly more costly than upgrading existing non-core assets to core, wherever possible. In addition, Wilshire believes that the Investment Committee should provide guidance to Staff on the duration of the legacy portfolio, in order that it not have an infinite life and simply be a repository for problematic investments. We believe that a finite, but appropriately lengthy, window to upgrade or liquidate the legacy portfolio will provide urgency to the ongoing management of those assets.

Second, Wilshire notes that the focus on the debt service coverage ratio as the governing limit on debt does allow for some greater insight into the portfolio. Since the portfolio will be more focused on income generation going forward, DSCR is a better gauge of how highly levered a set of investments is. However, DSCR does not include the non-amortizing portion of any portfolio debt (i.e., balloon payments would not be reflected). Therefore, in most years, DSCR will understate the true potential cash needs imposed on the portfolio from the debt. Refinancing, cash infusions into the real estate program, and other options exist for mitigating these potentially higher debt payments. Additionally, the Investment Committee is presented with a debt maturity schedule regularly which captures these additional debt service requirements.

Last, Wilshire has some concerns about the elimination of the REIT portfolio from the real estate portfolio. While REITs are represented in the Global Equity program and would not be totally eliminated from the total fund, removing any REIT allocation from the real estate portfolio forces every other asset class to be the "bank" for the liquidity needs of the real estate program. Under normal circumstances, buying or selling equity or fixed income securities when real estate is managing capital calls is unlikely to be a significant issue. However, as was the case during 2008, there could be times when the real estate portfolio's liquidity needs places stress on other asset classes – thus, the total fund. Some of this concern would be mitigated by the transition to a greater focus on cash flow generation and stability. However, if REITs are eliminated from the real estate portfolio, CalPERS' need for accurate cash flow forecasts from all asset classes is increased. REITs also act as a means for Staff to reduce asset allocation underweights for the Real Estate asset class. If RE is 3% below target, for example, REITs can be employed to bring the asset allocation back in line far quicker than might be accomplished using direct investments

Conclusion

Wilshire views the proposed Strategic Plan favorably. We believe this strategic transition to a greater concentration on stable, income producing properties will enhance the true diversification properties of the real estate portfolio and adheres to the intent of the asset class as it was presented during the asset allocation study.

Should you require anything further or have any questions, please do not hesitate to contact us.

Best regards,